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## The Capital Question

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# Why Do Banks Need More Capital?

## The Core Issue

The banking industry's modern history may be assumed to have started in 1934. From that date to the present, banks have rarely held as much equity as a percent of assets as they are holding today. In fact, if reserves are viewed as equity, which in essence they are, the industry has never had this much equity as a percent of assets in modern times. The question that arises from this history is what has changed that the industry must now increase its capital ratios?

One answer might be that banks hold large amounts of assets in places not on their balance sheet, assets where the bank has a residual interest and a risk of significant loss. However, while this argument may have been correct a number of years ago, it is no longer true today given the changes in the regulations.

A second question relates to the nature of capital. Why is it perceived to be so important? Bank accounting, which might be the most atrocious ever created, obscures the true value of assets and capital. It is based on the premise that money flows through a banking organization are not as relevant as the assumed value of assets. This is a terrible error. It clouds the true value of assets and capital.

The whole issue of tangible capital is misunderstood. The nature of reserves is a falsehood foisted on the public. What is missing in the industry's explanation of capital is the fact that liquidity, not capital, not reserves, represents the true safety valve of a bank.

If the discussion of capital was relegated to a medieval monastery and discussed along with the number of angels that fit on the head of a pin, it would be fine. The problem, however, is that the capital discussion is not being held in some obscure place. Flawed though it may be this discussion is being held in the public domain and laws and regulations are being influenced by the discussion.

The result is the creation of a banking system that is inhibited in its ability to grow the American economy. Capital regulation is one of the many tools being used by the American government to de facto take over the operations of the banking industry. Others include price controls, operating guidelines, increased regulatory burdens, capital market limitations, and consumer "protection" agencies.

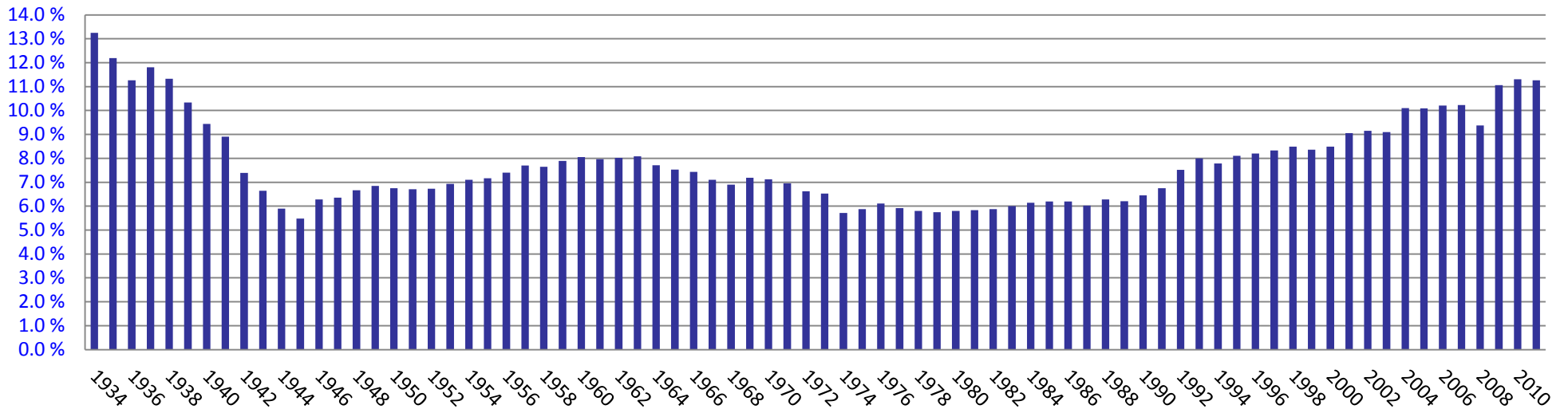
American banks are too small and must get bigger to meet the nation's needs. The de facto nationalization of the industry will be more harmful than is currently understood.

### Common Equity to Assets

The last year that equity was this high as a percent of assets was 1938, 74 years ago. In the interim, the industry has both survived and assisted the growth of the American economy without the need for higher capital ratios.

This data was provided by the FDIC concerning all commercial banks in the United States

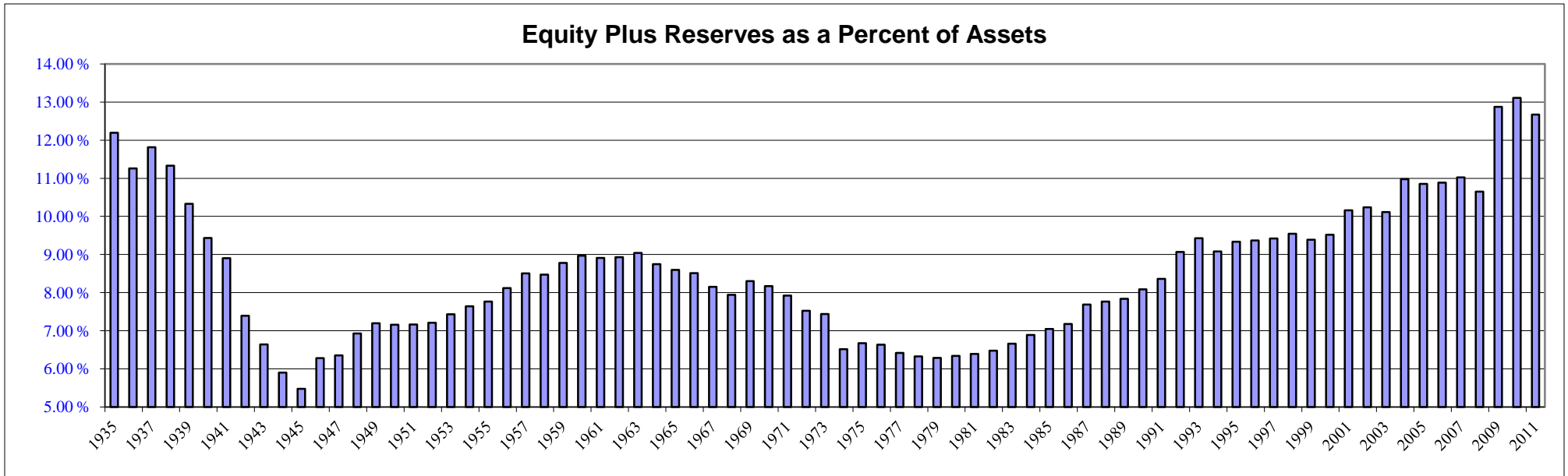
Equity as a Percent of Assets



### Equity Plus Reserves as a Percent of Assets

The past three years have represented the highest ratios ever recorded for reserves plus equity as a percent of assets for America’s commercial banks.

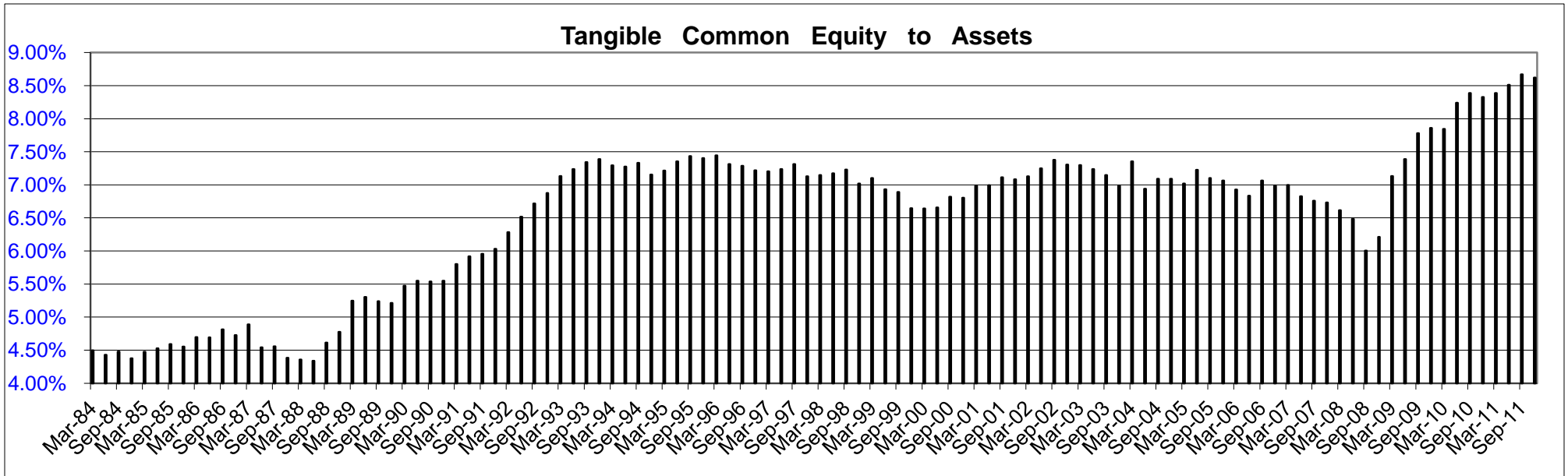
This data was provided by the FDIC concerning all commercial banks in the United States



### Tangible Common Equity to Assets

The FDIC only started providing data on tangible common equity in 1984. It has never been this high as a percent of assets since the series began.

This data was provided by the FDIC concerning all FDIC-Insured institutions in the United States

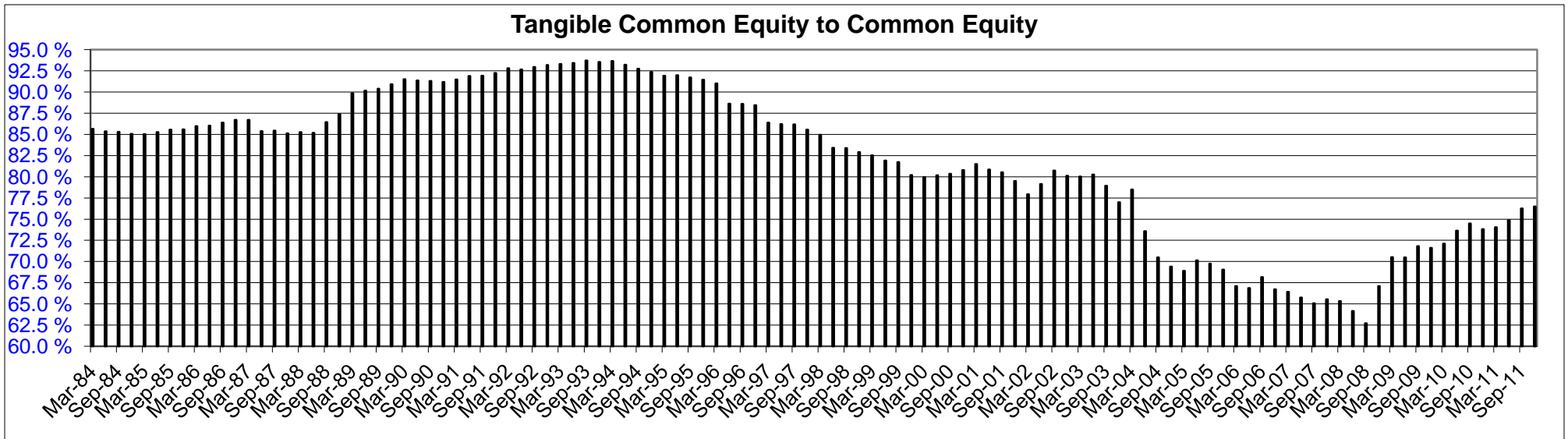


### Tangible Common Equity to Equity

The ratio of tangible common equity to common equity has fallen dramatically from the early 1990s to the present time. The primary reason for this is that banks changed their business models in that period. Following the banking crisis of the late 1980s and the demands for more capital, reserves, and liquidity, bankers made the decision to hold less of the assets that they originated on their balance sheets and to enter businesses that were less capital intensive.

The result was increased activity in asset management, payment systems, capital markets and similar pursuits. In the last banking crisis these businesses were not the source of banking losses. The losses stemmed from loans and securities. In essence, the losses stemmed from the capital intensive businesses operated by the banks. Many of those businesses most associated with the creation of intangible assets did not lose money. In fact they actually retained their values. This was not true of capital markets activity.

If the businesses that are most associated with intangibles were to be sold, they would not be sold at book value. Thus, to assume that these businesses are only worth book value is not valid. Yet, this is what the tangible common equity ratio does.



### Safer Bank

The table below is a synopsis of the balance sheets of two banks in 2006. Both have roughly the same amount of common equity to assets. However, in the nine quarters from the fourth quarter of 2007 to the fourth quarter of 2009, Citigroup (C/\$33.05/Buy) reported a pretax loss of \$68.7 billion or 57.4% of its equity. Northern Trust (NTRS/\$47.56/Buy) reported a pretax profit of \$2.1 billion in this same time frame or an amount equal to 53.9% of its equity.

The difference between these two banks was not capital. It was liquidity. If Citigroup's common equity was double the actual amount in 2006 an Northern Trust had half the amount of common equity, Northern Trust would still have been the safer bank.

The mantra that more and more capital will protect the banking industry makes no sense. High liquidity ratios and solid underwriting protects a bank. Capital does not.

	2006			
	<u>Citigroup</u>	<u>Northern Trust</u>	<u>Citigroup</u>	<u>Northern Trust</u>
	Billions		% of Assets	
<b>Assets</b>				
Cash	\$69.0	\$20.4	3.7%	33.6%
Securities	\$667.5	\$12.4	35.4%	20.4%
Loans	\$670.3	\$22.5	35.6%	37.0%
Other	\$477.5	\$5.4	25.3%	9.0%
Total Assets	\$1,884.3	\$60.7	100.0%	100.0%
<b>Funding</b>				
Deposits	\$712.0	\$43.8	37.8%	72.2%
All debt	\$596.0	\$7.7	31.6%	12.7%
Other Liabilities	\$456.5	\$5.2	24.2%	8.6%
Total Liabilities	\$1,764.5	\$56.8	93.6%	93.5%
Equity	\$119.8	\$3.9	6.4%	6.5%

### Absurd Accounting (I)

The four largest universal banks in the United States have \$7.3 trillion in fair value assets and \$5.3 trillion in fair value liabilities. The two largest investment banks have \$1.2 trillion in assets and \$0.7 trillion in liabilities. These assets and liabilities are spread across three different classifications known as Levels 1,2,and 3.

Every quarter each of these six institutions must in essence mark a portion of these assets and liabilities to market and record the changes in earnings. The basis for doing this is the belief that the institutions sell all of their assets and buy back all of the designated financial instruments on the last day of the quarter and then put them all back on the first day of the next quarter.

Of course this will never happen. But bank accounting forces the banks to record billions in losses or billions in profits to reflect an event that will never happen. The theory is that the assumed change in value is more important than what the institution actually earned or lost in the quarter and that this made-up number should be recorded as an adjustment to capital.

What is even more ironic is that if a bank's quality improves its DVA loss soars. Thus, as the bank gets better it earnings are artificially lowered and in theory it needs more capital.

<u>Institution Name</u>	<u>Sumbol</u>	<u>Fair Value</u>	
		<u>Assets</u>	<u>Liabilities</u>
Bank of America Corporation	BAC	\$2,493,449,000	\$2,027,939,000
Citigroup Inc.	C	\$1,701,464,000	\$1,232,816,000
JPMorgan Chase & Co.	JPM	\$2,672,053,000	\$1,964,021,000
Wells Fargo & Company	WFC	<del>\$462,978,000</del>	<del>\$116,432,000</del>
Sub-Total		\$7,329,944,000	\$5,341,208,000
Goldman Sachs Group, Inc.	GS	\$772,133,000	\$420,215,000
Morgan Stanley	MS	<del>\$405,153,000</del>	<del>\$243,848,000</del>
Sub-Total		\$1,177,286,000	\$664,063,000
Sub-Total			
Totals		\$8,507,230,000	\$6,005,271,000

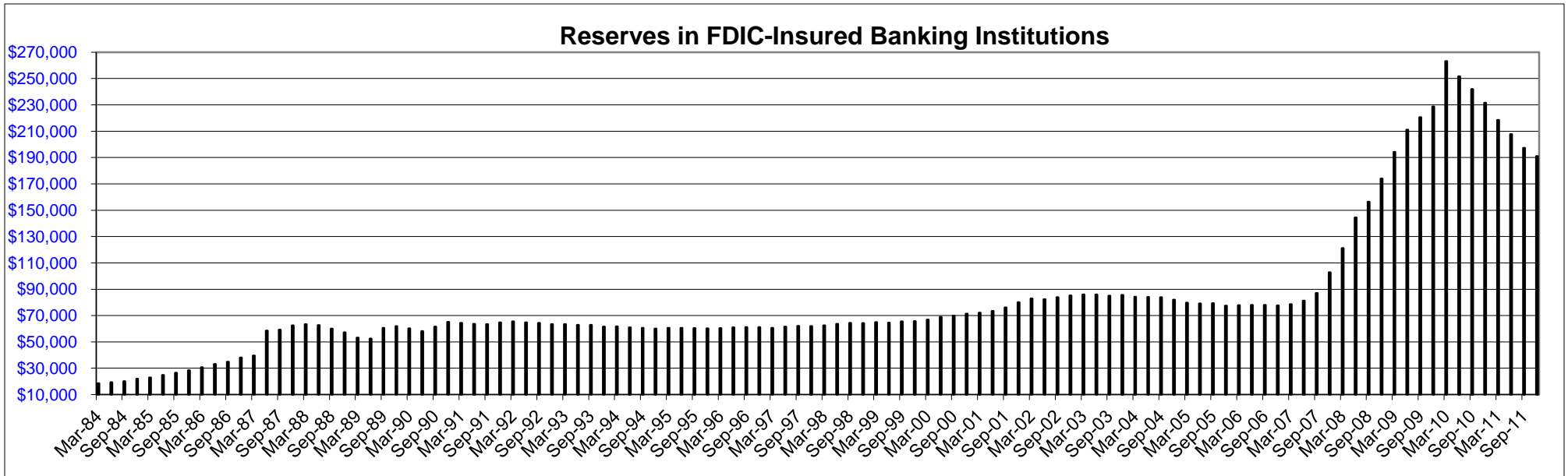


### Absurd Accounting (II)

The chart below represents “reserves” in FDIC-Insured banks from 1984 to the present. The problem is that there are no reserves in the FDIC insured banks if one thinks of reserves as a pool of funds set aside to be available when problems arise. There is no such pool of funds called reserves. However, every quarter, analysts and investors spend an inordinate amount of time determining whether this fund, that does not exist, is big enough or not.

In reality the accounting reserve which exists only on computer based balance sheets is a mark-to-market device. Yet, bankers will argue that they have no intention to mark-to-market their loan portfolios.

From a capital standpoint, the swings in the reserves have an impact. If reserve building is high, then capital is low and may have to be rebuilt. Thus, based on a made up number representing a pool of funds that does not exist, banks adjust their capital which means little in the overall safety of a bank.

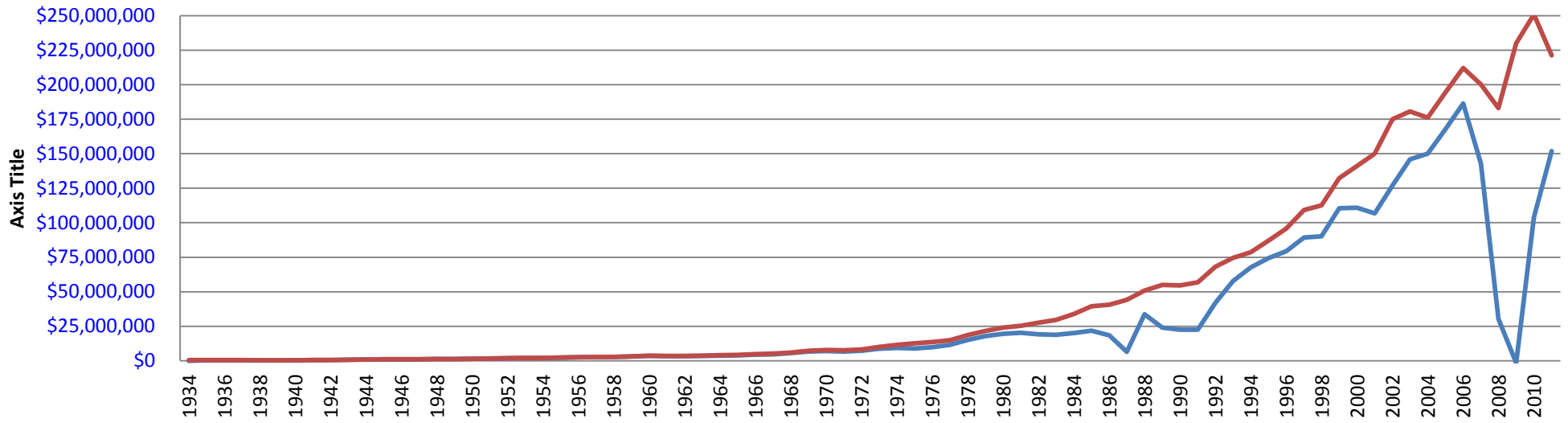


### Pre-Provision Pretax Earnings

The market has a solution to the problems created by absurd accounting. It ignores the resulting numbers. The reserve number is ignored in favor of pre-provision, pretax earnings. In publishing the earnings number, the fair value adjustment is taken out by everyone. Analysts, the media, and investors do not use reported earnings to value common stocks any longer because they do not accept the numbers as representing the true earnings of the company in question..

Capital analysis becomes a game played by the accountants and the regulators. In the real world, these numbers are understood to be spurious. However, in the real world because the accountants and regulators take them seriously, they have real market impacts. Thus, an accounting system that is rejected as being realistic, which no investor will use, is being used to harm the system.

**Pretax, Pre-Provision Earnings Compared to Pretax Earnings from 1934 to 2011**



**Killing Growth (I)**

The table below presents data for a hypothetical bank that has a cash and securities to asset ratio of 20% and a equity to asset ratio of 6%.

	<b>Scenario</b>
<b>Assets</b>	<b>I</b>
Cash	\$5
Securities	\$15
Loans	\$70
Other	\$10
Total Assets	\$100
<b>Funding</b>	
Deposits	\$62
All debt	\$20
Other Liabilities	\$12
Total Liabilities	\$94
Equity	\$6
Cash & Securities to Assets	20.0%
Equity to Assets	6.0%

### Killing Growth (II)

The bank must raise its equity to asset ratio to 7.0%. To achieve this result, the bank:

1. Raises 5% more in equity,
2. Sells off 14% of its loan portfolio, and
3. Reduces its short-term debt by a little more than 50%.

	Scenario	Scenario
	I	II
<b>Assets</b>		
Cash	\$5.0	\$5.0
Securities	\$15.0	\$15.0
Loans	\$70.0	\$60.0
Other	\$10.0	\$10.0
Total Assets	\$100.0	\$90.0
<b>Funding</b>		
Deposits	\$62.0	\$62.0
All debt	\$20.0	\$9.7
Other Liabilities	\$12.0	\$12.0
Total Liabilities	\$94.0	\$83.7
Equity	\$6.0	\$6.3
Cash & Securities to Assets	20.0%	22.2%
Equity to Assets	6.0%	7.0%

### Killing Growth (III)

The bank must raise its equity to asset ratio to 7.0%. To achieve this result, the bank:

1. Raises 5% more in equity,
2. Sells 14% of its loan portfolio, and
3. Reduces its short-term debt by a little more than 50%.

Now that its equity ratio is in line, the bank must get its liquidity ratio to 28%. To do this it:

1. Sells another 8% of its loan portfolio, and
2. Puts the proceeds into cash.

	Scenario	Scenario	Scenario
	<u>I</u>	<u>II</u>	<u>III</u>
<b>Assets</b>			
Cash	\$5.0	\$5.0	\$10.0
Securities	\$15.0	\$15.0	\$15.0
Loans	\$70.0	\$60.0	\$55.0
Other	\$10.0	\$10.0	\$10.0
Total Assets	\$100.0	\$90.0	\$90.0
<b>Funding</b>			
Deposits	\$62.0	\$62.0	\$62.0
All debt	\$20.0	\$9.7	\$9.7
Other Liabilities	\$12.0	\$12.0	\$12.0
Total Liabilities	\$94.0	\$83.7	\$83.7
Equity	\$6.0	\$6.3	\$6.3
Cash & Securities to Assets	20.0%	22.2%	27.8%
Equity to Assets	6.0%	7.0%	7.0%

### Killing Growth (IV)

The bank must raise its equity to asset ratio to 7.0%. To achieve this result, the bank:

1. Raises 5% more in equity,
2. Sells 14% of its loan portfolio, and
3. Reduces its short-term debt by a little more than 50%.

Now that its equity ratio is in line, the bank must get its liquidity ratio to 28%. To do this it:

1. Sells another 8% of its loan portfolio, and
2. Puts the proceeds into cash.

The bank is informed that the risk weighting formula has been changed and that it is a SIFI. So it

1. Increases its equity by 16%, and
2. Lowers its deposits by 2%

Overall, due to this process, the bank's size was cut by 10% and its loan portfolio by 21%.

	Scenario I	Scenario II	Scenario III	Scenario IV
<b>Assets</b>				
Cash	\$5.0	\$5.0	\$10.0	\$10.0
Securities	\$15.0	\$15.0	\$15.0	\$15.0
Loans	\$70.0	\$60.0	\$55.0	\$55.0
Other	\$10.0	\$10.0	\$10.0	\$10.0
Total Assets	\$100.0	\$90.0	\$90.0	\$90.0
<b>Funding</b>				
Deposits	\$62.0	\$62.0	\$62.0	\$61.0
All debt	\$20.0	\$9.7	\$9.7	\$9.7
Other Liabilities	\$12.0	\$12.0	\$12.0	\$12.0
Total Liabilities	\$94.0	\$83.7	\$83.7	\$82.7
Equity	\$6.0	\$6.3	\$6.3	\$7.3
Cash & Securities to Assets	20.0%	22.2%	27.8%	27.8%
Equity to Assets	6.0%	7.0%	7.0%	8.1%

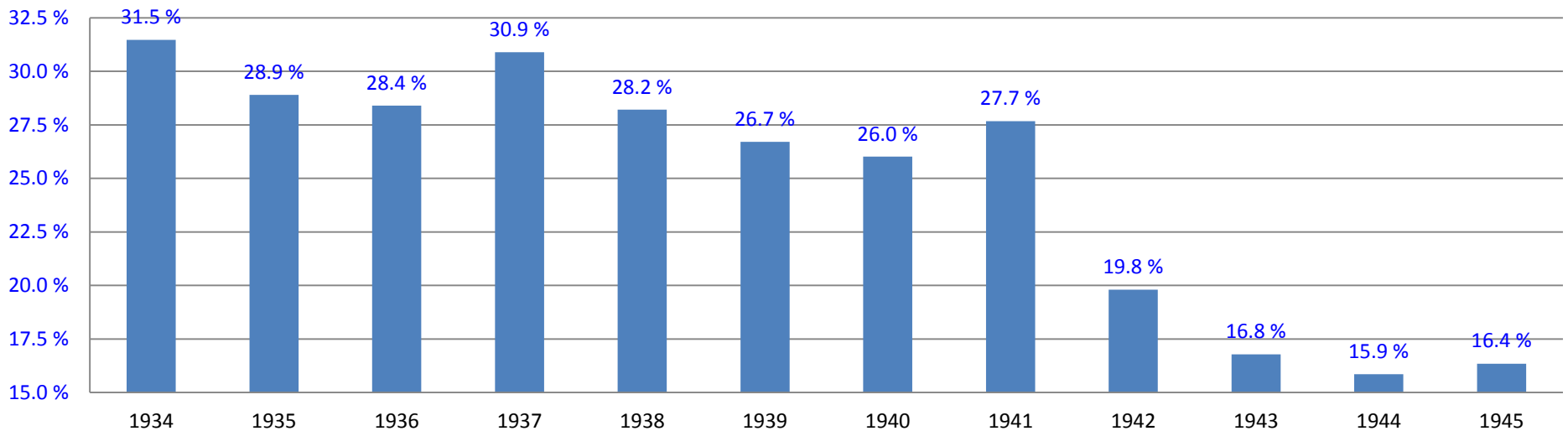
### Safe Banking Results

In 1934, America had recovered from the bank holiday imposed by the president. The banks embarked on a policy of safety and soundness.

Just before the United States became involved in World War II, in 1940, cash and securities were 71.4% of industry assets. Common equity was 9.4% of assets.

Loans were rapidly becoming an instrument of the past and the economy stayed in Depression.

### Loans as a Percent of Assets from 1934 to 1945



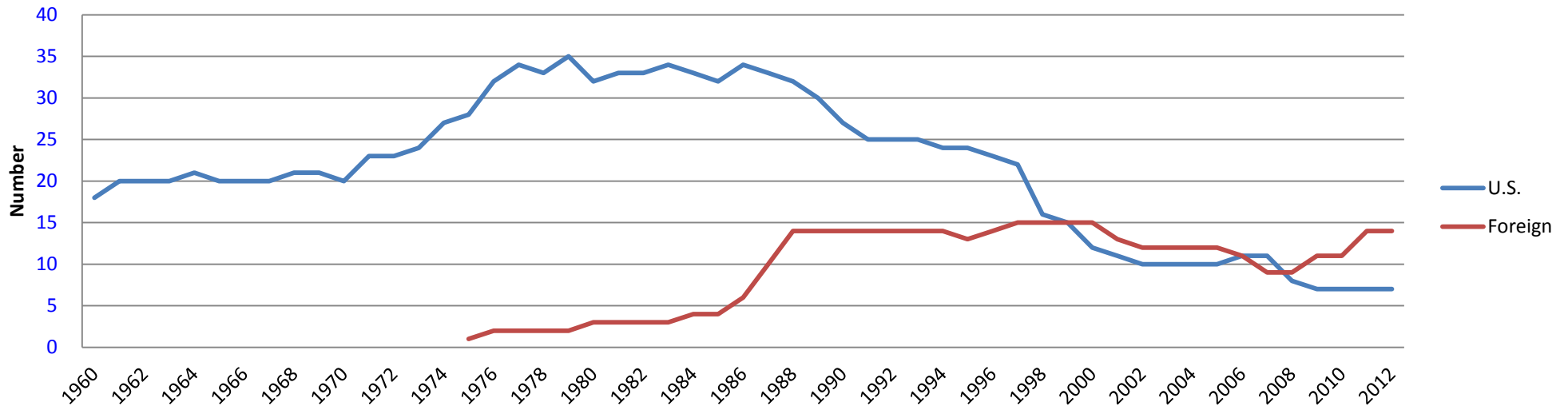
### Final Thought

The excessive requirements to raise bank capital and eliminate the concept of “Too Big to Fail” is a call for isolationism in banking. The United States is in no position to do this. In 1983, there were 34 American banks and bond houses acting as primary dealers to distribute Treasury securities and to maintain liquidity in the Treasury markets. That year there were 3 foreign companies also designated as primary dealers.

Today, there are 7 U.S. banks acting as primary dealers and 14 foreign banks in this position. There are more European banks involved in this effort than American (8 to 7). The United States has ceded the responsibility for raising the money to pay for the U.S. debt to foreigners.

If capital raising schemes are not abandoned, this country will be at the total mercy of foreign banks and investors to pay the U.S. debt. This makes no sense whatsoever.

### Number of Primary Dealers by Domestic and Foreign Location





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SELL	29

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**Hold/Neutral** Company either is not creating value (i.e., its costs exceeds its return on capital) or it is trading at a price equal to or in excess of its intrinsic value. Expectation is at best stock will perform in-line with market. If not currently held, stock should be avoided.

**Sell** Company's cost of capital exceeds its return on capital; and the company has no intrinsic value or is trading at a significant premium to its intrinsic value. Expect stock to under-perform the market over next twelve months.